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Supreme Court of the United States

October Term, 1976

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**No. 76-1165**

ZOLLER & DANNEBERG EXPLORATION, LTD. AND ZOLLER & DANNEBERG, INC.
Petitioners,

*vs.*

THE BALLARD & CORDELL CORPORATION,
Respondent.

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# BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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## STATEMENT OF THE CASE

The Ballard & Cordell Corporation ("B&C") supplements Petitioners' Statement of the Case as follows. (Zoller & Danneberg Exploration, Ltd., and Zoller & Danneberg, Inc., shall be collectively referred to herein as "ZDI".)

ZDI had extensive experience and expertise in the oil and gas industry. It had engaged in exploration, drilling, operating wells, and acquiring oil and gas properties, including producing properties, such as the two wells involved in this transaction. ZDI had a complete staff of technical people, including petroleum engineers, petroleum geologists, accountants, and landmen, and regularly used an independent petroleum consultant. The two wells ZDI sought to acquire from B&C were operated by Texas Oil and Gas Corporation ("Texas"). In the past, ZDI had participated in a number of drilling deals with Texas, and in fact had acquired the 25% working interest it already held in one of the two wells by participating in the original drilling of that well with Texas. (Petitioners' Appendix C, p. vii)

In connection with offering the sale of its 50% working interest in the two wells, B&C mailed brochures to ZDI. These brochures specifically advised all interested purchasers that the data and information was for preliminary evaluation only and recommended that interested purchasers contact B&C for additional data and information. ZDI never contacted B&C, instead relying upon its own in-house technical staff and its own independent petroleum consultant to gather pertinent data and information from the operator, Texas. (Petitioners' Appendix B, p. ix; Petitioners' Appendix C, pp. viii and xxi)

Both the independent petroleum consultant for B&C and the independent petroleum consultant for ZDI separately sought current well data from Texas. For reasons which were never determined at trial, Texas supplied

B&C's consultant with pressure data which it neglected to supply to ZDI's consultant. However, the well pressure data which was supplied to B&C's consultant and which was utilized in formulating the opinion he rendered B&C was wrong. (Petitioners' Appendix B, pp. ix-x; Petitioners' Appendix C, p. xx)

The independent petroleum consultants of both B&C and ZDI prepared reservoir evaluations of the two wells for their respective clients. ZDI complains herein of the failure of B&C to disclose to ZDI the evaluation of its consultant; however, as a prospective purchaser, ZDI failed to disclose to B&C the evaluation of its consultant. (Petitioners' Appendix B, p. xi; Petitioners' Appendix C, p. xx) Moreover, the practice of the industry in buying and selling producing property is to not disclose these opinions in transaction between oil and gas companies. (Petitioners' Appendix B, p. xi; Petitioners' Appendix C, p. xx)

The trial court struck Petitioners' anti-fraud claims under the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act"); however, the trial court did consider the same claims under common law fraud and ruled against Petitioners on the merits (Petitioners' Appendix B, pp. viii-xi), which conclusion was affirmed by the court of appeals. (Petitioners' Appendix C, p. xxii)

## SUMMARY OF ARGUMENT

This case does not present the considerations set forth in Rule 19 of this Court's Rules for granting a review on writ of certiorari. The decisions of the trial court and court of appeals are: (1) consistent with the opinions of the three courts of appeals which have considered the transfer of working interests in oil and gas wells; (2) consistent with the regulatory purpose of the securities laws; and (3) consistent with the decisions of other courts of appeals which have considered the investment contract issue.



## ARGUMENT

(1) B&C owned undivided 50% working interests in two producing wells which it contracted to sell to ZDI. Consummation of the sale to ZDI would have resulted in the transfer of B&C's entire interest in both wells. Prior to the purchase and sale agreement, ZDI already owned an undivided 25% working interest in one of the two wells. Both companies had extensive experience and available expertise in all phases of the oil and gas industry. Prior to the decision under consideration herein, three courts of appeals have concluded that under factual settings similar to the one under consideration herein, the sale of the entire working interest, even if it has been previously fractionalized, does not constitute the sale of a security. *Lynn v. Caraway,* 252 F. Supp. 858 (W.D. La. 1966), *aff'd,* 379 F.2d 943 (5th Cir. 1967), *cert. denied* 393 U.S. 951 (1968); *Graham v. Clark,* 332 F.2d 115 (6th Cir. 1964); *Woodward v. Wright,* 266 F.2d 108 (10th Cir. 1959). No court of appeals has ruled to the contrary, and review by writ of certiorari is not indicated.

*Woodward v. Wright, supra,* involved the sale of a 15/16th working interest in a producing well to four purchasers. The sale contract clearly contemplated the splitting of that interest among the four purchasers. Relying upon this Court's reasoning in *S.E.C. v. Joiner Leasing Corp.,* 320 U.S. 344 (1943), the court of appeals concluded that Congress did not intend to bring the sale of all oil and gas leases and fractional parts thereof under the scope of the securities statutes, but only those patterns of splitting which were utilized to raise the money for speculative purposes. Accordingly, the court of appeals held that if the owner transfers the whole of what he owns, there is no creation of a fractional undivided interest, even though the interest he has sold represents something less than the entire well. Conversely, the court held that because Wright split the working interest among a number of purchasers, he created a

security in the form of fractional undivided interests in oil and gas rights.

In *Graham v. Clark, supra,* the defendants sold all of their lease interest in acreage upon which wells were producing. The court of appeals held that because defendants sold their entire working interest, the transaction did not constitute the sale of a security.

*Lynn v. Caraway, supra,* involved an action against Jones, an owner-operator, and Allison, a lease broker. Pursuant to a sale agreement, Jones purchased the fractional interests in a producing well from his co-owners and sold the entire unit to Allison. Allison, in turn, split the unit and sold fractional interests therein to a number of purchasers. The court held that Jones was not liable under the registration and anti-fraud provisions of the 1933 Act because he did not offer or sell a security. Allison, however, was held to have sold a security.

The decision of the court of appeals in this case is in accord with the decisions of all of the courts of appeals which have considered this question. Petitioners argue that the reasoning of these courts would result in the conclusion that had B&C sold its 50% working interest to ZDI and Exxon, the sale would have constituted the sale of a security. These are not the facts which were presented below, and under the facts presented to this Court in Petitioners' Petition for Writ of Certiorari, the conclusion of the court of appeals is proper.

(2) Petitioners argue for a "liberal" construction of the definition of a security. A liberal construction does not necessarily lead to the conclusion that a transaction involves the sale of a security. Courts, including this Court, have looked to the economic substance of the transaction rather than its form in order to accomplish the purposes intended by Congress. This process not only places transactions within the scope of the securities statutes which, by their form,



appear beyond these statues, but places beyond the scope of these statutes transactions which, by their form, appear to be within their scope. Two areas of securities litigation which offer a sound demonstration of this process are a number of recent decisions by courts of appeals involving arguments that notes are securities, and this Court's treatment of stock sold in connection with low-income cooperative housing in *United Housing Foundation v. Forman,* 421 U.S. 837 (1975).

Both the 1933 Act and the 1934 Act provide, in part, "[t]he term 'security' means any note . . . ." Applied literally, all notes would be securities, which would result in the application of the regulatory process and remedies to transactions far beyond the abuses Congress sought to remedy. The courts have generally resisted a literal application, electing instead to gauge each transaction to the abuses Congress sought to correct.

In *Zabriskie v. Lewis,* 507 F.2d 546 (10th Cir. 1974) Mrs. Zabriskie had engaged Lewis to locate investments for her, who in turn had introduced her to Worthen. In a series of transactions, Mrs. Zabriskie loaned money to Worthen to be utilized in promoting a corporation in exchange for promissory notes. The decision of the court of appeals considers two initial points well established: first, not all notes are securities despite the wording of the statutes; and second, despite the fact that the 1934 Act excludes from the scope of its definition notes with a maturity date of less than nine months, such notes may in fact be a security. The court observed that the test in determining whether a note is or is not a security is based upon the purpose of the 1933 and 1934 Acts to protect investors and the practical consideration of subjecting commercial notes to the registration requirements and subjecting the federal courts to the anti-fraud litigation that would ensue. The court, in concluding that Mrs. Zabriskie's notes constituted the sale of securities,

relied upon the fact that she had been seeking investments, that she was an unsophisticated investor, that she was not ordinarily in the business of making loans, that she had been advised her funds would be used to promote a corporation, and that she was promised 120% return on her money.

In *Bellah v. First National Bank of Hereford, Texas,* 495 F.2d 1109 (5th Cir. 1974), plaintiffs executed a promissory note in connection with their livestock business, which note was secured by a deed of trust and renewed several times thereafter. Plaintiffs alleged misreprsentations in connection with renewal of the note and sought relief under Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder. The court, in analyzing the transaction, distinguishes transactions involving commercial paper and those involving investment paper, concluding that in this case the transaction was a commercial transaction and that it accordingly did not constitute the sale of a security. The court considered its conclusion that commercial paper transactions were beyond the scope of the 1934 Act buttressed by the observation that a contrary view would subject all such transactions to possible registration requirements and subject the courts to a substantial increase in anti-fraud litigation under the securities statutes.

In *S.E.C. v. Continental Commodities Corp.,* 497 F.2d 516 (5th Cir. 1974), Continental Commodities' option trading was suspended. Thereafter Continental Commodities issued promissory notes to its customers in partial reimbursement for their discretionary trading accounts. The court concluded, after examining the transaction, that the notes were not issued in connection with liquidation of the enterprise, but with the intent of retaining the customers' money and rejuvenating the enterprise. The court, accordingly, held the notes constituted the sale of a security.

In each of the foregoing promissory note cases, and in the many other note cases which have been recently decided, the courts have elected to ignore the literal definition, choosing instead to examine each transaction in an effort to determine whether the transaction, regardless of its name, falls within the scope of the abuses Congress sought to correct.



*United Housing Foundation v. Forman, supra,* involved a low-income housing cooperative. In connection with apartment rentals, Riverbay Corporation offered "stock" to all tenants, the amount of stock issued being determined by the number of rooms the particular tenant leased. The issued stock was tied to each apartment and transfer to non-tenants was prohibited. The stock carried none of the rights normally associated with stock, such as voting rights. Participation in cooperative affairs was determined by the number of residents in an apartment unit, not the number of shares of stock held. At termination of occupancy, a tenant was required to offer the stock to Riverbay at the tenant's initial purchase price. The stock was in fact a rental deposit. During construction, Riverbay circulated an information bulletin to prospective tenants. The bulletin estimated the rental rates of the apartment; however, because of increased construction costs, the rental rates ultimately charged were raised without disclosure in a subsequent information bulletin. A number of tenants sued under the anti-fraud provisions of the 1933 and 1934 Acts, seeking damages and rental reductions. The Court, in concluding the transaction did not involve the sale of a security, despite use of the term "stock," stated:

> "The primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market. The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect

the interest of investors. Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction and not on the name appended thereto." 421 U.S. at 849

In similar fashion, the 1933 Act provides, "[t]he term 'security' means . . . fractional undivided interest in oil, gas, or other mineral rights . . ." and the 1934 Act provides, "[t]he term 'security' means any . . . participation in any . . . oil, gas, or other mineral royalty or lease . . . ." The strict application of this definition would impose restrictions, create remedies, and increase federal anti-fraud litigation beyond that contemplated by Congress, and beyond the protection Congress intended to create. This Court in *S.E.C. v. Joiner Leasing Corp., supra,* stated:

"Oil and gas rights posed a difficult problem to the legislative draftsman. Such rights were notorious subjects of speculation and fraud, but leases and assignments were also indispensable instruments of legitimate oil exploration and production. To include leases and assignments by name might easily burden the oil industry by controls that were designed only for the traffic in securities. This was avoided by including specifically only that form of splitting up of mineral interests which had been most utilized for speculative purposes." 320 U.S. at 352.

The B&C sale to ZDI does not fall within the area of abuse referred to above and the abuses Congress sought to correct. The transaction involved the sale of producing property. Money was not sought by B&C for speculative purposes. ZDI's capital was not needed to promote a venture, and ZDI, accordingly, was not contributing risk capital. The wells were operated by a third party, Texas, and ZDI had equal access to any data and information it deemed pertinent, as well as the expertise to gather and



evaluate that data. In fact, the well which was eventually plugged, thereby precipitating the litigation herein, (see the trial court's Findings of Fact, Petitioners' Appendix B, p. vii) was 25% owned by ZDI prior to its negotiations with B&C.

The considerations involved in determining the existence of a security are analyzed in Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?,* 18 Western Reserve L. Rev. 367 (1967). The author suggests the following guidelines:

"A 'security' is:

(1) A transaction in which

(2) a person ('buyer') furnishes value ('initial value') to another ('seller'); and

(3) a portion of initial value is subjected to the risks of an enterprise, it being sufficient if—

(a) part of initial value is furnished for a proprietary interest in, or debt-holder claim against, the enterprise, or

(b) any property received by the buyer is committed to use by the enterprise, even though the buyer retains specific ownership of such property; or

(c) part of initial value is furnished for property whose present value is determined by taking into account the anticipated but unrealized success of the enterprise, even though the buyer has no legal relationship with the enterprise; and

(4) at the time of the transaction, the buyer is not familiar with the operations of the enter-

prise, or does not receive the right to participate in the management of the enterprise; and

(5) the furnishing of initial value is induced by the seller's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above initial value, will accrue to the buyer as a result of the operation of the enterprise." 18 Western Reserve L. Rev. at 377.

None of ZDI's "initial value" was subjected to the risks of the enterprise — it was not required for the enterprise, which was already operational. ZDI was equally familiar with the operations and upon completion of the transaction would have been the 50% working interest owner in one well and the 75% working interest owner in the other. The management participation afforded ZDI is more fully described in the next portion of this brief. Finally, Professor Coffey commences his definition by defining a security as a "transaction." This is of course consistent with the abuses Congress sought to correct. Petitioners' brief refers to the writings of several commentators in the securities field. The thrust of their discussions in criticizing *Woodward v. Wright, supra,* and the decisions which followed *Woodward,* is that once you create a security, it remains a security forever. This analysis focuses on the piece of paper rather than the underlying transaction. This analysis looks to the form rather than the substance. It is the transaction which must be examined in each instance, and the transaction presented to this Court in Petitioners' writ did not constitute the sale of a security.

(3) Upon completion of the sale to ZDI, ZDI would not have been looking to the essential management efforts of others for the success of the enterprise and, accordingly, the sale was not an investment contract.



The wells ZDI contracted to purchase were producing wells. To the extent management efforts affected the success of the enterprise, these efforts were expended at and before drilling. Moreover, the wells were operated by Texas. B&C would have retained no interest and ZDI would have held a 75% working interest in one and a 50% working interest in the other. To the extent managerial efforts affected the success of the operation, ZDI would have played, or had the right to play, a significant role in those efforts. ZDI had the right to complete access to the wells and the operator's books and records; had the right to control any extraordinary expenditures and the right to control the selection of any new operator. After ZDI refused to complete the contract to purchase B&C's interest in the two wells, it continued to hold a 25% working interest in the one well. As a 25% working interest owner, ZDI participated in the decision to rework that well and voluntarily contributed its proportionate share of the expenses required to rework the well. To the extent managerial efforts were required by anyone, ZDI was an active participant.

Petitioners argue that the Dare To Be Great litigation, *S.E.C. v. Glenn W. Turner Enterprises, Inc.,* 474 F.2d 476 (9th Cir. 1973), *cert. denied,* 414 U.S. 821 (1973); *S.E.C. v. Koscot Interplanetary, Inc.,* 497 F.2d 473 (5th Cir. 1974); *Miller v. Central Chinchilla Group, Inc.,* 494 F.2d 414 (8th Cir. 1974) has created a conflict among the courts of appeals as to the factors which determine the existence of an investment contract.

The facts in the Dare To Be Great litigation are considerably different than the facts in the present litigation. In that litigation it was argued that because the investor was not solely looking to the efforts of others, it was not an investment contract. The investor's participation was restricted to bringing a prospect to the sales meeting,

even being instructed against advising the prospect in advance of the nature of the meeting. The investor thereafter relied upon the efforts of others to generate the sales environment necessary to expand the pyramid. The courts ruled that although the investor was required to lend some participation, the undeniably significant efforts, those essential managerial efforts which affected the success or failure of the enterprise, were contributed by others.

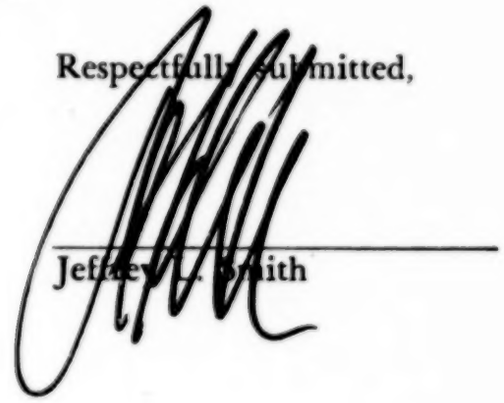
These cases do not create a conflict among courts of appeals. Each court is careful to indicate that it does not intend to redefine the nature of a security. 474 F.2d at 483; 494 F.2d at 417; 497 F.2d at 483. Indeed, the court in *S.E.C. v. Koscot Interplanetary, Inc., supra,* reconciled its opinion with the opinions of the Tenth Circuit Court of Appeals. 497 F.2d at 481. There is very little difference between the investor's role in the Dare To Be Great litigation of bringing the next prospect in for a sales presentation and the opportunity afforded investors in *Continental Marketing Corp. v. S.E.C.,* 387 F.2d 466 (10th Cir. 1967), *cert. denied* 391 U.S. 905 (1968) to raise their own beavers. Petitioners are not entirely accurate in suggesting that the Tenth Circuit Court of Appeals absolutely requires that the investor depend *solely* upon the efforts of others.

## CONCLUSION

The transaction Petitioners present to this Court for review did not involve the sale of a security. The trial court and court of appeals did, however, consider the merits of Petitioners' defense of fraud at common law, among many other defenses, and ruled in favor of Respondent. Petitioners assert that this Court must review the securities issues they have already unsuccessfully raised with two courts. The holding of the court of appeals is consistent with the securities decisions of this Court and the other courts of appeals and to adopt the position of Petitioners will substantially change the regulatory scheme and remedies of the oil and gas industry. Petitioners' Petition for Writ of Certiorari should be denied.



Respectfully submitted,



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